[JOINT COMMITTEE PRINT]

ANALYSIS OF PROPOSALS RELATING TO COMPREHENSIVE TAX REFORM

SCHEDULED FOR HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS

BEGINNING ON FEBRUARY 27, 1985

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

FEBRUARY 26, 1985

U.S. GOVERNMENT PRINTING OFFICE

43-949 O WASHINGTON : 1985 JCS-3-85

J 862-3

H782-3

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INTRODUCTION

This pamphlet[1] has been prepared by the staff of the Joint Committee on Taxation in connection with the tax hearings before the House Committee on Ways and Means, to begin on February 27, 1985. The hearings concern fundamental tax reform and other tax issues.

Part I of the pamphlet discusses the general objectives of comprehensive tax reform. Part II describes the basic characteristics of base broadening and rate reduction proposals. Part III analyzes some important issues in considering major modifications to the income tax. Part IV deals with problems of making a transition from the present system to a new system. The Appendix summarizes both the Treasury Department's proposal (November 1984) for tax reform and comprehensive tax reform bills which have been introduced so far during the 99th Congress. The pamphlet concludes with a short bibliography of publications relating to material discussed in the text.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Analysis of Proposals Relating to Comprehensive Tax Reform* (JCS-3-85), February 26, 1985.

I. OBJECTIVES OF COMPREHENSIVE TAX REFORM PROPOSALS

Several criteria are commonly used when evaluating tax proposals, including equity, efficiency, and simplicity. Individuals often agree that the revenue which is raised by the tax system should be collected in a manner which is as fair as possible, which produces as little unintended distortion in the economy as possible, and which is as simple to administer and understand as possible. In addition, certain provisions of the tax system have been enacted to encourage specific activities which Congress has felt should be promoted. The questions of equity, efficiency, simplicity, and the encouragement of specific activities are central to the discussion of whether the present tax system should be changed by enacting one of the comprehensive tax proposals currently being discussed.

A. Equity

Horizontal equity and ability to pay taxes

A common assertion is that taxes, other than user fees collected from beneficiaries of specific programs, should be collected in accordance with a taxpayer's ability to pay taxes. Thus, taxpayers with equal ability to pay taxes should pay equal amounts of tax and, correspondingly, in comparing any two taxpayers with different levels of ability to pay, the taxpayer with a greater ability to pay should pay more tax than the other. This concept is sometimes called horizontal equity. An additional dimension of equity, sometimes known as vertical equity, is the actual amount by which the tax liability of the taxpayer with the higher ability to pay exceeds that of the other taxpayer.

Income as a measure of ability-to-pay

To apply concepts of equity to the design of a tax system, it is necessary to measure each taxpayer's ability to pay taxes. In the United States, there is a tradition that a taxpayer's income is a valid measure of his or her ability to pay taxes. In this context, income is defined as the ability to provide oneself with goods and services, other than those goods and services which are necessary to earn the income. Thus, for this purpose, income is generally measured by subtracting from the sum of the gross receipts and appreciation in asset value of a taxpayer the amounts spent on goods or services which are costs of generating those gross receipts and that appreciation.

Although there are many problems obtaining all the information necessary to produce an accurate measure of income (some of the most important problems are discussed in the third part of this pamphlet), income is a commonly accepted measure of ability to pay taxes. It is often asserted that individuals with a relatively

high ability to purchase goods and services which satisfy needs for private consumption also have a relatively high ability to purchase those goods and services which provide for public consumption needs, i.e., goods and services provided by the government. If it is then agreed that those with a relatively high ability to purchase these goods and services should also be required to make a relatively high contribution toward defraying their cost, then it follows that the revenues necessary to pay for government spending should be raised by an income tax.

On the other hand, several arguments may be put forth as to why income should not be relied on as the basic index of ability to pay taxes. First, some assert that actual consumption of goods and services, not potential consumption (i.e., income), is a fairer basis for taxation. This is consistent with the belief that taxation should be based on the actual satisfaction derived from goods and services, rather than the ability to purchase them, and actual satisfaction may be more closely related to expenditures for goods and services than to income.

Second, it can be argued that income may be misleading as a single index of ability to pay taxes because no account is taken of the time and effort expended on earning that income. Many would agree, for example, that someone who works 20 hours per week to earn a given amount of income should pay more tax than someone who works 40 hours per week to earn the same amount. This is because the former taxpayer has greater leisure time to enjoy the available goods and services and because one's leisure is itself valuable. Similarly, it may be argued that someone who works at a less pleasant job should pay less than someone with the same income who works in a more pleasant environment. Yet, under a tax system in which tax liability is based solely on income, no account is taken of these differences, and it would be extremely difficult to design a tax system that took these and similar problems into account.

A third problem is disagreement over what expenses should be subtracted from gross receipts as a cost of earning income. For example, questions have arisen about the extent to which business meals and entertainment should be deductible.

Vertical equity

In spite of these problems, income has been commonly accepted as a basis for taxation in the U.S. Thus, the horizontal equity concept requires that taxpayers with equal incomes should have equal tax liabilities. Vertical equity is much more subjective since it involves the comparison of ability to pay for taxpayers with different amounts of resources. Since there is no widely accepted yardstick for making these comparisons, the degree to which tax liability should increase with income is a value judgment.

The concept of progressivity is often discussed in this context. A progressive tax is one for which the ratio of tax liability to the tax base (e.g., income) rises as the tax base rises. Many argue that this is appropriate. On the other hand, others contend that the ratio of taxes to income should be constant (a proportional tax system). Still others believe that it is acceptable for the ratio of taxes to income to decline as income rises (a regressive system).

One argument for progressivity is that, if people examined the vertical equity question from the point of view of the very beginning of their lives, when they did not know their capabilities and resources and exactly where they would end up in the income distribution, they would be willing to agree to laws under which government would mitigate, to some extent, whatever inequalities emerged from a market economy. Progressivity is criticized, however, by those who view a taxpayer's income as essentially the fruit of his or her own labor and resources. Under this view, the government should have very little role in equalizing the amounts with which individuals are left after taxes, since individuals are entitled to whatever income arises from their own labor or property. This view is, in turn, contested by those who contend that labor and property have value only because society establishes laws and regulations which allow each individual to engage in economic activity with relatively little interference from others. To be sustained, these laws and regulations must be accepted even by those who are relatively unsuccessful. Thus, because society establishes the framework which allows labor and property to be valuable resources, it can also establish a progressive tax system and other mechanisms to achieve a more equitable distribution of income.

In sum, although equity is an integral part of tax policy, it involves subjective judgments over which there is likely to be considerable disagreement.

B. Efficiency

Another widely accepted goal of tax policy is that taxes should interfere as little as possible with the incentives to engage in specific types of economic activity, except to the extent that Congress intends such effects. This goal is known as economic efficiency.

Virtually any tax which meets accepted equity criteria creates some interference with economic incentives. In order to have no such effect, a tax would have to be determined on the basis of some characteristic over which an individual has no control. For example, a head tax equal to a specified, constant amount per person would have no incentive effects, since it could not be avoided, but it also would be regarded by most as extremely unfair. On the other hand, a tax which varies with income creates a disincentive for earning additional income. Even taxes on consumption create disincentives for earning additional income since they reduce the potential amount of goods and services which may be purchased with the income earned from a given amount of property or work effort.

Similar trade-offs may exist with respect to vertical equity and efficiency. For example, it has been argued that a progressive tax system creates considerable inefficiency by encumbering additional income with the imposition of a still higher tax rate. In the extreme case, a 100-percent tax on additional income would eliminate any incentive to earn that income. Yet, from the point of view of equity, many argue that progressive tax rates are essential to establish a proper relationship between tax burdens and ability to pay. Therefore, given the notions of horizontal and vertical equity that are commonly accepted, there is frequently a conflict between the efficiency and equity goals of tax policy. Balancing these com-

peting considerations is one of the most difficult aspects of formulating a tax system.

The concept of economic efficiency uses as a benchmark the production of goods and services which would occur in a market economy in the absence of taxes. Economists generally regard this allocation of resources as a useful reference point because, under certain conditions, it insures that available economic resources are arrayed in such a way as to produce the highest possible amount of consumer satisfaction. Relative to this benchmark, taxes change the incentives to engage in various types of economic activity (e.g., work, investment, consumption of specific goods and services), which reduces the ability of the economy to satisfy consumer demands.

Thus, some inefficiency is inherent in virtually all taxes which are acceptable from the equity standpoint. However, a major goal of tax policy is to reduce this inefficiency to as low a level as possible.

C. Simplicity

A third goal of tax policy is simplicity. This is a serious concern for at least two basic reasons—compliance costs and the perception of equity.

First, a complicated tax system requires a large amount of resources to administer and understand. When the system has a large number of discrete provisions and mandates that many fine distinctions are to be made among types of income or expenses, a long series of complicated rules is necessary. The agency administering the system must have a large staff to formulate the rules and to insure that taxpayers calculate tax liability correctly. Taxpayers themselves must invest large amounts of time in understanding the rules so as to avoid overpaying their taxes, or alternatively, find that they are better off by paying for professional advice and tax return preparation. This time and effort diverted from other activities is a source of inefficiency generated by the tax system in addition to the disincentive effects described in the previous section.

A second reason for a general preference for a simple tax system is that under a complicated system, similarly situated taxpayers may have different tax liabilities because they are not equal in their ability to understand the rules or pay for professional tax advice. The fact that investing valuable time and resources in tax planning may yield significant tax savings may undermine the perception that the tax system is horizontally equitable, among both those investors who do make such investments and those who do not. Taxpayers may suspect that others are paying less tax not because they have lower ability to pay, but rather because they have better access to knowledge about the details of the system. If these feelings are widespread, they may contribute to a feeling that the system is not fair.

A very simple tax system, however, may rank low from the equity and efficiency viewpoints. For example, it clearly is simpler not to attempt to include in the tax base those elements of income that are the more difficult to measure. But failure to include them

would lower the equity of the system by not imposing equal taxes on individuals with equal incomes; the efficiency of the system also would be lowered because individuals are induced to rearrange their affairs so that more of their income is of the excluded type. As another example, a rule-of-thumb method for computing a particular deduction might be adopted, in the interest of simplicity, in lieu of a complicated method that yields exact results. But if the simpler method is too inexact, or becomes so over time, it will be criticized as unfairly producing deductions that are much too large in some cases and much too small in others. In this case, transactions may be structured systemmatically to exploit the inaccuracy of the rule-of-thumb method, inefficiently diverting resources to projects that may produce little of value but nevertheless generate adequate after-tax returns because of the associated tax benefits. Thus, as with other elements of tax policy, a balance must be struck among competing objectives in evaluating the simplicity of a tax system.

D. Stimulating Specific Activities

Some provisions of the tax law have been enacted to encourage particular activities by businesses and individuals rather than to promote the goals discussed above. For example, when Congress enacted tax credits for energy conservation expenditures, it did so not to increase the equity, efficiency, or simplicity of the tax system, but rather to increase spending on goods which reduce energy consumption. This subsidy could have been provided through a spending program, but, instead, the tax system was chosen as the means by which the subsidy was administered.

In certain cases, there are advantages to providing subsidies through the tax system, since it provides an administrative mechanism, already in place, reaching a large majority of the American public. The speed and dependability of conveying subsidies through the tax system has been contrasted with the possibly protracted and inaccessible operations of bureaucracy which would ration subsidies if made available through a spending program.

At the same time, providing the subsidy through the tax system rather than some other mechanism may tend to interfere with the equity of the tax system. These subsidies result in a system in which tax liability is not made equal for taxpayers with equal ability to pay, and they change the relationship of tax liabilities for taxpayers with different levels of ability to pay. Further, such subsidies make the system more complicated, and may raise questions of efficiency. Although the provision of these subsidies through another administrative mechanism also would involve similar issues of equity, efficiency, and simplicity, taxpayers' perceptions of the workings of the entire tax system may be affected when they are administered through a tax mechanism.

II. CHARACTERISTICS OF COMPREHENSIVE TAX PROPOSALS

The Appendix of this pamphlet provides a summary description of both the Treasury Department's tax reform plan, reported in late 1984, and the comprehensive tax proposals which have been introduced in the House and Senate so far during the 99th Congress. While the details of these proposals vary substantially, it is useful to categorize into five groups the changes they would make in the present tax system:

(1) The bills generally would expand the tax base by repealing a variety of deductions, exclusions and credits in the present system.

(2) Marginal tax rates applied to the base would be lowered substantially.

(3) The degree of steepness in the rate schedule, the rate at which marginal tax rates increase with income, would be reduced.

(4) The aggregate distribution of tax burdens by income class would be altered by some of the proposals.

(5) The total amount of revenue raised by the corporate and individual income taxes may be changed by some of the proposals.

This part of the pamphlet considers some of the features of the present income tax which are relevant to these issues and contains a general discussion of them.

A. Changes in the Tax Base

Virtually all of the proposals under discussion would make substantial changes in the tax base, so that significant items not now subject to tax would be included in the base.

Many of the proposals adopt a relatively comprehensive definition of income as the primary basis for taxation. The designers of most of the proposals appear to have made the judgment that income is the best measure of taxpaying capacity and that taxpayers with equal income should have equal tax liability. In addition, it appears that they believe that many of the exclusions, deductions, and credits in the present system are inequitable, inefficient, or complex, or at least have decided that the benefits that these provisions may have are outweighed by the advantages of the other changes made by the proposals, such as reductions in marginal tax rates.

Important background for analyzing these base-broadening proposals is provided by comparison of the amount of income actually subject to tax under the present individual income tax and the income recorded in the national income and product accounts. Table 1 presents the relationship between gross national product and taxable income in the United States in 1982, the latest year for which sufficient data are available for this purpose.

Gross national product was more than double the estimated individual income tax base—$3.1 trillion versus $1.2 trillion. The $1.9 trillion difference is composed of two parts. First, about $0.2 tril-

lion of income items are included in the tax base but not gross national product. These include certain government subsidies and transfer payments, certain interest income, and a portion of capital gains. Although not included in GNP, many would argue that these are properly includible in an income tax base. In fact, substantial additional portions of transfer payments and capital gains would be subject to tax under various proposals.

TABLE 1.—RECONCILIATION OF GNP AND TAXABLE INCOME, 1982

[In billions of dollars]

Item	Amount
Gross national product (GNP)	3,069.3
−Depreciation	−358.8
−Indirect business taxes	−258.8
−Statistical discrepancy	−0.5
+Government subsidies	+8.8
−Corporate retained earnings and corporate income tax	−92.6
−Employer social insurance contributions	−140.0
+Net interest paid by government and consumers	+105.7
+Taxable government transfers	+35.5
−Fringe benefits excluded from AGI	−153.3
−Imputed income in GNP	−74.3
−Investment income of insurance companies and pension funds	−62.2
−Investment income of nonprofit organizations and fiduciaries	−25.9
−Differences in accounting treatment between GNP and AGI	−30.9
−Income of nonfilers and unreported income	−170.5
−Other discrepancies between GNP and AGI	−42.1
−IRA deductions	−27.8
−Second-earner deduction	−8.9
+Capital gains in AGI	+32.5
+Taxable private pensions	+42.4
+Subchapter S corporation income	+0.2
Adjusted gross income (AGI)	1,847.8
−AGI on nontaxable returns	−51.5
−Medical deduction	−17.2
−Tax deduction	−85.4
−Interest deduction	−111.9
−Charitable deductions	−32.1
−Other deductions	−18.0
+Floor under itemized deductions (zero bracket amount on itemizing returns)	+100.0
−Personal exemptions	−190.7
Taxable income on taxable returns (net of deficits)	1,441.0
−Deduction equivalent of tax credits (estimated)	−21.2
−Zero bracket amount (estimated)	−220.0
Tax base (estimated)	1,199.8
Individual income tax after credits	276.9

Sources: *Survey of Current Business*, July 1984; *Statistics of Income: SOI Bulletin*, Winter 1983-84 and Spring 1984, Internal Revenue Service; and staff estimates.

The second component of the difference between GNP and taxable income is approximately $2.1 trillion of income and deduction items which are included in GNP but not in the tax base. Much of this difference, however, would not be available for net base broadening under a revised income tax. First, approximately $0.6 trillion consists of economic depreciation and indirect business taxes, which may be considered as costs of earning income. Second, $0.1 to $0.2 trillion of income is not reported; subjecting this amount to tax would depend on compliance measures rather than changes in the statutory tax base. Third, corporate retained earnings were approximately $0.1 trillion. This amount already is subject to tax at the corporate level, and thus a substantial portion of this may not be available for broadening the combined base of the corporate and individual taxes. Fourth, the approximately $0.5 trillion accounted for by the zero bracket amount, personal exemptions, adjusted gross income on nontaxable returns, and income of nonfilers whose income is below the filing requirement is most usefully thought of as part of the rate structure. (Equity considerations lead the designers of all these proposals to exempt some amount of income from tax, using either a zero bracket amount, personal exemptions, tax credits or a combination of these approaches). The total of these four amounts generally not available for base broadening is approximately $1.3 trillion. Thus, of the $2.1 trillion of items not included in the tax base under the present system, about $0.8 trillion is left for possible inclusion in the base of a comprehensive tax on net income. This consists of about $0.6 trillion of fringe benefits, investment income of pension plans and nonprofit organizations, and other items not included in adjusted gross income, and about $0.2 trillion of itemized deductions (in excess of the zero bracket amount) and tax credits. If these items had been included in taxable income in 1982, the tax base would have been approximately 60 percent larger.

The proposals summarized in the Appendix broaden the tax base considerably by increasing the amounts of capital gains, transfer payments, fringe benefits, investment income and other income items included in the tax base and by reducing allowable deductions and credits.

B. Lowering Marginal Tax Rates

In all of the proposals, marginal tax rates are substantially reduced. This reduction appears to be motivated by efficiency and equity considerations.

Efficiency

Many economists would agree that high marginal taxes can cause considerable economic inefficiency, both by interfering with the incentives for work and saving, and by magnifying the effects caused by differences between the tax base which may be chosen

purely for efficiency reasons and the base which actually is implemented in the law.

An individual's marginal tax rate is the rate applicable to the last or to the next dollar of income received. If an individual is subject to a 25-percent marginal rate, then the return to additional work effort and saving is reduced by 25 percent. For example, if this individual is considering working on an overtime assignment which pays $40, then the after-tax reward to this work effort is $30. A higher marginal tax rate would reduce the return to this work effort even further, affecting the incentive to undertake the assignment. A similar point may be made with respect to investment decisions. If the individual with a 25-percent marginal rate invests in a security with a 10-percent return, the after-tax return would be 7.5 percent. Thus, the marginal tax rate affects the incentive to save rather than use the same resources for current consumption. The same reasoning may be used to show that marginal tax rates also influence the incentives to engage in activities which are heavily taxed versus those which are lightly taxed. With high marginal rates, for example, there is more incentive to invest in lightly taxed investments or to take jobs in which a high proportion of compensation is non-taxable than would be the case with low marginal rates.

Effect on labor supply

The effect of changes in marginal tax rates in distorting incentives is sometimes referred to as the "substitution effect." Most of the studies which have been performed on the effect of after-tax wage rates on work effort have found that the substitution effect of after-tax wage changes in hours worked is quite small for husbands but rather large for wives, especially wives with children. Since the substitution effect is measured by holding after-tax income constant, this is the proper measure of the incentive effect of a marginal rate reduction, as opposed to the "income" effect which would occur because of the income increase attributable to any tax reduction. This empirical finding is confirmed in one of the more sophisticated studies,[2] except that a significant substitution effect is found for husbands, as well as wives. Thus, these studies indicate that if marginal tax rates were lowered, holding other factors (including after-tax income) constant, some individuals would be willing to work a larger number of hours. This could be manifested as greater willingness to work full-time instead of part-time, greater acceptance of overtime assignments, less absenteeism, and a larger number of individuals in the labor force.[3]

It should also be noted that there are several other possible impacts of marginal tax rates on work-related activities. First, it has been argued that reduction in marginal tax rates could improve compliance with the income tax, although there is little evidence

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[2] Jerry A. Hausman, "Labor Supply," in Henry J. Aaron and Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior*, Brookings Institution, 1981.

[3] It should be noted that a tax proposal which raised after-tax income could have offsetting "income" effects because some individuals would respond to their additional income by taking more leisure time. Thus, the evidence of a significant substitution effect does not mean that a tax cut would necessarily increase labor supply, only that a cut in marginal tax rates offset by other changes in after-tax income would do so.

which bears directly on this question. Second, it has been argued that high marginal tax rates have induced employees to demand a larger portion of their compensation in the form of tax-free fringe benefits, such as health insurance, than would be the case with lower marginal rates, and this substitution of fringe benefits for cash may reduce the efficiency with which the economy satisfies employees' needs. To the extent that such effects exist, they would be lessened if marginal tax rates were lowered.

Effect of marginal tax rates on saving

If an individual saves a dollar rather than spending it on current consumption, he or she generally will be able to have in excess of one dollar available for consumption in a future period. The amount of this excess depends on the return available for funds saved and on the marginal tax rate applicable to this return. The quantity of consumer goods which can be purchased in the future with a given amount of money will depend on the rate of inflation. Thus, the after-tax return (adjusted for inflation) determines the extra future consumption that a person can have by saving and sacrificing one dollar of current consumption. The lower the after-tax return, the more attractive is the option to consume now rather than save. As an important determinant of the after-tax return, the marginal tax rate is likely to affect this choice.

As in the above analysis of work effort, it is important to distinguish between the income and substitution effects of marginal tax rate changes on the choice between current and future consumption. Any tax reduction, including a reduction in marginal rates, will increase after-tax income and thus generally will lead to an increase in both current and future consumption. However, as discussed above, marginal tax rate reductions also would have incentive, or substitution effects, because they change the rate at which the taxpayer can trade off between current and future consumption. This discussion emphasizes the substitution effects, which are unique to marginal tax rate reductions and which measure the economic inefficiency created by taxes.

Three distinct sources of concern with high marginal tax rates have been cited by economists who have analyzed the effects of the income tax on current and future consumption. The first concern is the effect of the marginal tax rates on individuals' incentives to consume in current rather than future periods; the second is the effect of marginal tax rates on aggregate saving, investment, and productivity; and the third involves the effect of the tax system on the composition of saving as a result of its effect on incentives to invest in lightly taxed versus heavily taxed activities and the incentive to borrow—the deduction for nonbusiness interest.

The fact that the marginal tax rates implicit in the current income tax discourage future consumption creates a distortion (relative to a tax system with a marginal rate of zero, such as a per capita head tax). The importance of this distortion depends on the responsiveness of future consumption to a change in the after-tax rate of return on saving, holding income constant. Empirical studies of this sensitivity are much less numerous than those of labor supply response. The methodological difficulties of studying the responsiveness of consumption to the rate of return are greater be-

cause the expected real return (net of expected inflation) must be measured and because the statistical analysis must be performed using time series of observations on total U.S. income and consumption. This methodology requires the assumption that the quantitative relationships among the variables have been unchanged for a long period of time. In spite of these methodological problems, some empirical studies do indicate that individuals' plans for future consumption are sensitive to the after-tax rate of return. The marginal tax rate on capital income also may affect the choice between labor and leisure, as well as the choice between present and future consumption. For example, a greater after-tax rate of return may make it more attractive for individuals to work and save for the purpose of increasing their consumption in retirement years. (Similarly, a higher after-tax return to work effort may also have this effect, establishing a connection between saving and the marginal tax rate on labor income.) However, this sort of effect has not been firmly substantiated in empirical research.

The second major concern which has been raised concerning the effect of marginal tax rates on capital income has been their effect on aggregate savings and, thus, investment and productivity. For a variety of reasons, however, the link between aggregate investment and the marginal tax rates in the individual income tax is very uncertain. First, investment may be affected much more directly by other factors, such as the tax treatment of depreciation allowances. Second, the effect of income tax changes on private saving could be offset to the extent that there is a revenue loss, which leads to less government saving. Finally, even though it is likely that a higher after-tax return may increase future consumption, it is not clear as a theoretical matter that personal savings would increase simultaneously. This is the case because a higher return on savings actually lowers the amount which an individual needs to save in the current period in order to achieve any future consumption goal. Personal saving would increase in response to an increase in the after-tax rate of return only if desired future consumption increases sufficiently to offset this effect. Whether this is, in fact, the case can be determined only by empirical studies. Although these studies are extremely difficult to perform for the reasons discussed above, there is some indication that future consumption may be stimulated sufficiently by increasing the after-tax return that total personal saving may increase modestly in response to such a change.

The income tax also influences decisions about the particular forms in which taxpayers do their saving, which affects the allocation of capital in the economy. The first concern is that the income tax imposes heavy tax rates on some activities and low or negative tax rates on others (e.g., tax shelters, owner-occupied housing, and precious metals). This provides an incentive to shift from the heavily taxed activities, which may be more productive, to lightly taxed activities. The size of this incentive depends on the marginal tax rate. Thus, it is argued, reducing the marginal tax rate may encourage individuals to shift from less productive to more productive forms of saving. The second concern relates to the present law deduction for nonbusiness interest. Since this provision is, in effect, an encouragement for borrowing, i.e., dissaving, it is argued that reducing marginal tax rates could encourage saving by reducing

the incentive to borrow. Finally, it is argued that because the income from assets subject to capital gains treatment is taxed only when the assets are sold, high marginal tax rates discourage sales and prevent these assets from being employed in their most efficient uses. Thus, lower marginal income tax rates could increase efficiency by reducing this "lock-in" effect.

The proposals described in the Appendix tend to take several approaches to improving saving incentives. Most of the proposals attempt to achieve greater uniformity in the tax treatment of saving and income from capital by reducing or eliminating preferential treatment for certain types of saving relative to others. Also, the proposals reduce marginal tax rates, which reduces the adverse impact of whatever distortions remain. Some of the bills, however, go farther than this and attempt to structure a system in which the effective tax rate on the income from saving is zero.

Equity

From an equity perspective, reducing marginal tax rates also may be viewed as desirable. Many argue that it is unfair for a high portion of each additional dollar of income earned by an individual to be absorbed as increased tax liability. In passing the Economic Recovery Tax Act of 1981, Congress lowered the highest marginal rate in the tax schedules from 70 percent to 50 percent. Much of the discussion of this change involved the belief that a marginal tax rate as high as 70 percent caused undue interference with the incentives for efficient economic performance. However, another important source of support for this reduction was the feeling that it was unfair for the tax system to claim more than half of each additional dollar earned by taxpayers. Presumably, this indicates that one accepted equity objective of tax policy is to keep marginal tax rates below some threshold level.

C. Reducing the Progressivity of the Rate Schedules

The authors of the proposals appear to believe that it is desirable to reduce significantly the number of tax brackets in the rate schedules and to reduce the difference between the bottom and top rates of the income tax. Some of the proposals have one flat tax rate that applies to all income not exempt from taxation.

It is important to emphasize that the issue of the degree of progressivity in the rate schedules is to some extent independent of the broad vertical equity issue of the relative distribution of tax burdens by income class. That is, the distribution of tax burdens is affected not only by the degree of progressivity in the rate schedules, but by other structural elements of the income tax as well. For example, during 1981 the Ways and Means Committee considered a proposal to reduce the number of brackets in the rate schedule, to widen the first bracket so that a majority of taxpayers were subject to the same tax rate, and to increase the personal exemption and zero bracket amount to offset the rate increases imposed on the lowest income taxpayers. These revised rate schedules produced approximately the same amount of progressivity as under prior law. Thus, some flattening of the rate schedule is possible even without large changes in the distribution of the tax burden.

There are several advantages to a flat or flattened rate schedule. For example, if taxpayers are more likely to be in the same tax bracket over a period of years, tax considerations would be less likely to influence the timing of transactions. This would reduce one of the sources of inefficiency of a progressive rate schedule. If most taxpayers faced the same tax rate, there would be less incentive to shift income to low bracket family members, which may improve the perception of equity in the system. The difference in tax treatment between married couples and single individuals would be reduced, since, in a system in which married couples may pool their income and file a joint return, this difference arises from the fact that the amount of income taxed at each rate depends on marital status. Finally, a flatter schedule of tax rates could allow a closer correspondence between amounts withheld and tax liability. In a system in which the tax rate did not depend on taxpayer's income, as is the case under the present social security payroll tax, withholding could be closer to tax liability in the vast majority of cases.[4] It should be emphasized that although some flattening is compatible with a progressive distribution of tax burdens, that is, a system in which tax liability as a percentage of income increases as income rises, adopting a rate schedule with just one rate would impose strict limits on the degree of progressivity which could be obtained. Some progressivity could be attained by exempting some fixed amount of income from taxation for all individuals, but the pattern of progressivity in the present system (discussed below) probably could not be duplicated.

D. Changing the Distribution of Tax Burdens by Income Class

One of the central issues in analyzing an alternative proposal is the relationship of the tax burdens of taxpayers with different levels of income. Table 2 presents the average tax rate projected under present law for 1986. In preparing this table, taxpayers were put into categories according to their expanded income, a concept somewhat broader than the present definition of adjusted gross income. This is not a comprehensive definition of income, since it does not take account of many additional items which might be included in the tax base under alternative proposals or other possible changes in the measurement of income. In addition, it does not reflect the income and tax liability of the corporations in which individuals own shares. However, using expanded income probably provides a good indication of how progressive the system would appear if the tax base was more comprehensive.

As shown in Table 2, the present individual income tax system exhibits a substantial degree of progressivity. The average tax rate rises from 2 percent to about 25 percent in the highest class. The rate in the highest income class is approximately double the average tax rate of 12 percent.

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[4] In 1982, there was about $63 billion of overwithholding and $29 billion of underwithholding. A change that eliminated most of the overwithholding, especially if it did not reduce the underwithholding significantly, could have major effects on budget receipts in the year it first took effect unless it were phased in.

TABLE 2.—AVERAGE TAX RATE ON EXPANDED INCOME UNDER PRESENT LAW, 1986 [1]

[1983 income levels]

Expanded income [2] (thousands)	Expanded income (millions)	Tax liability [1] 1986 law (millions)	Average tax rate (tax liability divided by income; percent)
Below $10	$149,648	$3,635	2.4
$10 to $20	369,922	29,064	7.9
$20 to $30	431,003	44,789	10.4
$30 to $40	344,521	41,564	12.1
$40 to $50	245,071	33,617	13.7
$50 to $75	208,215	32,972	15.8
$75 to $100	72,314	13,580	18.8
$100 to $200	95,100	21,228	22.3
$200 and above	123,032	31,314	25.5
Total	2,038,827	251,763	12.3

[1] This is preliminary data. Individual income tax liabilities include the refundable portion of the earned income credit but do not include changes made by the Deficit Reduction Act of 1984 to income averaging, the capital gains holding period, and certain other provisions.

[2] Expanded income equals gross income plus excluded capital gains and various tax preference items less investment interest to the extent of investment income. The expanded income statistics include all returns and exclude non-filers.

Choosing a pattern of distribution by income class depends primarily on the vertical equity considerations discussed above. As noted before, this is largely a matter of value judgment. Some argue that the present distribution pattern should be preserved in any alternative proposal while others may believe that the present distribution is either too progressive or not progressive enough. In addition, efficiency may be a consideration in the selection of the distribution of tax burdens, because the relatively high marginal tax rates on higher income taxpayers necessary to achieve the desired distribution may result in a significant increase in the inefficiency caused by the system.

E. Achieving Specified Revenue Targets

One of the key decisions which must be made in analyzing or designing a comprehensive tax proposal is the choice of a revenue target. According to the most recently published estimates of the Congressional Budget Office and the Office of Management and Budget (February 1985), budget receipts on a current services basis for fiscal year 1985 will be about $735 billion, which is more than $200 billion short of the amount needed to finance outlays projected on a current services basis. The individual income tax and the corporate income tax—the principal subjects of comprehensive tax reform proposals summarized in the Appendix—are expected to yield, respectively, 45 percent and 9 percent of total budget re-

ceipts. (Social insurance taxes and excise taxes are expected to yield about 36 percent and 5 percent, respectively, with customs duties, estate and gift taxes, and miscellaneous receipts completing the total.)

Clearly, if there is substantial base broadening with no changes in marginal tax rates, total revenue will be increased, and if marginal tax rates are lowered without changing the tax base, total revenue will be reduced. Several of the proposals appear to be designed so that the new combination of tax rates and tax base would produce approximately the same revenue as is expected under present law for a chosen fiscal year. However, if a judgment is made that this level is either too low or too high, base broadening and tax rate decisions can be adjusted accordingly.

F. Conclusion

Each of the comprehensive tax proposals under discussion would make changes in at least several of the five areas discussed above. It certainly would be possible to achieve base broadening by itself, although this would change the total revenue raised and the pattern of distribution by income class. Similarly, a proposal could be designed to reduce progressivity in the rate schedules while leaving the tax base, the distribution by income class, and total revenue unchanged. Marginal rates could be reduced or increased, making no changes in the tax base, but total revenue obviously would change. Even though the five areas may be logically distinct, substantial change in any one of these areas appears to bring into consideration other objectives. The balance among these objectives depends on the equity, efficiency, simplicity, and other tax policy considerations discussed in the first part of the pamphlet.

III. ISSUES IN DESIGNING THE TAX BASE

A. Overview

One definition of a person's income is the amount he could potentially consume over a period of time without reducing his wealth. Under this definition, income during a year would equal the person's actual consumption in the year plus the increase in his wealth (i.e., his savings) between the beginning and the end of the year. This, in turn, would equal the sum of wages, interest, dividends and other receipts, minus costs incurred in earning income, plus any appreciation, realized or unrealized, in the value of the person's wealth.

The present income tax base differs from this theoretical "accretion" concept of income in a number of respects. These can be divided into ways in which the basic tax structure fails to correspond to a pure income tax (structural tax issues) and specific tax provisions which are intended to provide incentives for taxpayers to engage in particular activities or to provide relief for particular types of taxpayers (tax expenditures).

B. Structural Tax Issues

Six of the principal structural income tax issues are the following:

(1) The definition of income from capital and the treatment of borrowing during periods of inflation.

(2) The taxation of corporate-source income.

(3) The treatment of noncash income.

(4) The treatment of unrealized income.

(5) The treatment of international transactions.

(6) The treatment of savings, and whether a tax on consumer expenditures would be more appropriate than an income tax.

This section of the pamphlet discusses these six structural issues.

1. Indexing the definition of income for inflation

Inflation creates a problem for an income tax because it increases the difficulty of defining taxable income from capital and of properly treating borrowing. A proper definition is necessary if ability to pay is judged to be measured by income and if efficiency considerations call for equal tax rates on income from various activities. This problem is most easily seen by considering a case in which a person buys an asset for $50,000, holds it for a period during which the general price level doubles, and sells that asset for $100,000. In reality, the taxpayer has experienced no real increase in his wealth and has no income from the sale of the asset; the purchasing power sacrificed in order to buy the asset is exactly equal to the purchasing power represented by the sale of the asset.

However, under present law, the taxpayer must report a long-term capital gain of $50,000, forty percent of which is included in adjusted gross income.

A similar problem arises in measuring depreciation. In theory, depreciation should be a measure of the real loss of value of an asset during a time period. A taxpayer who buys a building for $50,000 is presently able to claim cost recovery deductions amounting to $50,000 over an 18-year period. However, if rapid inflation occurs during that period, the purchasing power represented by the cumulative cost recovery deductions will be less than that sacrificed to purchase the building, and real income will not be measured exactly. The same problem arises in inventory accounting when businesses use the first-in, first-out (FIFO) method of accounting in periods of inflation, since increases in the value of inventory from inflation are treated as taxable income even though the increase does not result in any real increase in asset values.

The treatment of debt in periods of inflation also fails to conform to an exact measure of real income. Inflation enables the borrower to repay debt with less valuable dollars, which represents income to the borrower that currently goes untaxed. To the extent that interest payments rise to compensate for anticipated inflation, the additional interest is deductible; however, this component of interest is effectively a repayment of principal. Conversely, the erosion of the real value of indebtedness is a cost to the lender that he is currently unable to deduct, even though any additional interest to compensate for inflation is included in taxable income.

It should be noted that the issues discussed here relating to the definition of the income tax base are entirely separate from the effect of inflation in narrowing the real width of the tax brackets and reducing the real value of the personal exemption and the other fixed dollar amounts used to determine tax liability (so-called bracket creep). For the individual income tax for years after 1984, bracket creep was largely eliminated by the indexing provisions of the Economic Recovery Tax Act of 1981.

One way to deal with these definitional problems would be to enact a more comprehensive indexing program in which the definition of income from capital and the treatment of debt would be adjusted for inflation so as to achieve an accurate measure of real income. This would involve the following specific changes: (1) indexing the basis of assets by the rate of inflation for purposes both of computing gain or loss on the sale or exchange of those assets and of computing depreciation, depletion and other capital cost recovery deductions, (2) adopting a new system of inventory accounting in which costs would be indexed for inflation, (3) requiring borrowers to include in taxable income the gain that results when inflation erodes the real value of their debt, and (4) allowing lenders to deduct the loss that results when inflation erodes the real value of debt.

While the tax-writing committees have never considered such a complete indexing program, there has been serious consideration of some of its elements. In its version of the Revenue Act of 1978, the House passed an indexing adjustment to basis for capital gains and losses on corporate stock, real estate, and tangible personal property. In its version of the Tax Equity and Fiscal Responsibility Act of

1982, the Senate passed a similar provision applying to corporate stock and real estate. Indexing basis for purposes of computing depreciation deductions was discussed in the context of depreciation reform in 1980 and 1981.

There is little disagreement that a comprehensive income tax would not reach an accurate definition of income without indexing. However, comprehensive, exact indexing would add a good deal of complexity to the tax system, particularly the exact indexing adjustments for borrowing and lending. Even a program of partial indexing, limited to capital cost recovery and measurement of gain and loss on nonfinancial assets, would add significant complexity, which might not be worth the effort at sufficiently low rates of inflation.

In place of indexing the definition of income, Congress nas adopted several substitute approaches to alleviating the distortions created by inflation. The last-in, first-out (LIFO) method of inventory accounting is, in most cases, an adequate substitute for a more complicated indexed system. The exclusion for 60-percent of long-term capital gains and the ACRS method of recovering the costs of equipment and structures were both motivated, in some degree, by a desire to offset some of the distortions in income measurement caused by inflation. Furthermore, the distortion caused by the failure of the present system to make inflation adjustments for debt is reduced by the fact that the adjustments made by the borrower and lender would, to some extent, offset each other (and would be completely offsetting if the two had identical marginal tax rates).

These provisions, however, are themselves deviations from what would be appropriate in a comprehensive income tax and create some inequities and distortions which, to a degree, offset the benefits they provide in reducing the distortions created by inflation. For example, an *ad hoc* adjustment, like ACRS or the 60-percent capital gains deduction, will only be accurate at a single rate of inflation, and actual inflation rates are likely to be different. In fact, the present rate of inflation is significantly lower than the inflation rate at the time both the 60-percent capital gains deduction and ACRS were enacted.

Thus, there is no entirely satisfactory solution to the problem of properly defining the tax base in periods of inflation. Any solution involves trade-offs between complexity, equity, and various kinds of distortions.

2. Taxation of corporate income

Corporate integration

Under present law, corporate-source income is taxed at the corporate level under the corporate income tax. In addition, dividend distributions are taxed under the individual income tax, and increases in the value of corporate stock that result from earnings retention are taxed as capital gains to the shareholder. Clearly, this system does violence to the principle that all income be taxed alike. Dividends may be subject to a combined corporate and indi-

vidual tax burden as high as 73 percent.[5] Retained earnings bear a 46-percent corporate tax plus a capital gains tax when the shareholder sells his stock. Corporate-source income received by individuals, therefore, will generally be taxed at the same marginal tax rate as other kinds of income only in the case of corporations with zero effective tax rates who pay out all their earnings as dividends. In other cases, corporate-source income will be taxed more or less heavily than the shareholder's ordinary income.

The present system is held responsible for creating economic inefficiency by distorting several types of business decisions. Shareholders have an incentive to invest in assets other than corporate stock in order to avoid double taxation. Corporations have an incentive to finance their operations with debt rather than equity because dividends are not deductible, while interest payments are deductible (and hence not subject to double taxation). Corporations also have an incentive to retain earnings, rather than pay out dividends, to avoid double taxation if they can ultimately distribute that money to shareholders as part of a liquidation, through repurchase of their own shares or in connection with a takeover, the proceeds from which are usually subject to tax at capital gains rates. These distortions caused by the present system of taxing corporations have been blamed for reducing capital formation and productivity growth, preventing the allocation of capital to its most efficient uses, weakening the nation's financial structure through excessive reliance on debt, and encouraging mergers and acquisitions.

One way to treat corporate-source income would be to tax all of it, dividends and retained earnings, as if it were earned directly by shareholders. This is essentially the way subchapter S corporations are treated today. The corporate income tax could be retained as a withholding tax, for which shareholders would receive a refundable credit on their own tax returns just as they do for the present withholding taxes on wages.

Unfortunately, when applied to large corporations with complex structures, this type of complete integration of the corporate and individual income taxes presents serious technical problems.[6] As a result, much more attention has focused on simply reducing or eliminating the double taxation of dividends, without modifying the treatment of retained earnings. This can be done either through the dividend deduction approach or the shareholder credit approach.

The dividend deduction approach is the simplest way to eliminate double taxation of dividends. Corporations simply would deduct their dividends paid in determining taxable income, in effect exempting from the corporate income tax whatever income is distributed as dividends, leaving that income to be taxed once at the shareholder level.

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[5] For example, consider $100 of corporate-source income before taxes. There will generally be a corporate income tax of $46. If the remaining $54 is distributed as a dividend to a taxpayer in the 50-percent bracket, the individual income tax will be $27, for a combined tax burden of $73.

[6] For example, consider the situations in which two corporations own stock in each other. Neither would know how much income to report until it had heard from the other how much were the other's retained earnings. Also, there would be problems in tracing audit adjustments at the corporate level through to each of the shareholders.

Under the shareholder credit approach, a shareholder would make two adjustments. First, he would "gross-up" the amount of the dividend included in gross income by the amount of the corporate tax deemed paid with respect to that income. Second, he would claim a refundable tax credit for the amount of the gross-up. If the shareholder credits with respect to a corporation's dividends exceeded the amount of corporate tax actually paid by the corporation, the corporation would have to pay an additional tax to make up the shortfall.[7]

A number of considerations are relevant in choosing between these two approaches. The dividends-paid deduction is simpler. However, the shareholder credit provides flexibility under which, for example, the credit can be denied to tax-exempt organizations and foreign shareholders for whom there is no U.S. double taxation. This would reduce the revenue impact.

The argument for relieving the double taxation of dividends is stronger to the extent that the corporate income tax base is broadened. One problem that arises with the present relatively narrow corporate tax base is that many profitable companies have zero or low marginal tax rates because they use tax preferences, while others have substantial tax liability and are subject to the top 46-percent marginal tax rate. These differences create inequities and distortions among firms, which could be exacerbated if a new deduction for dividends paid or a shareholder credit were added to the system. The argument for relieving the double taxation of dividends is weaker to the extent that marginal tax rates in the individual and corporate income taxes are reduced from their present levels, since the size of the distortions caused by double taxation is directly related to these marginal rates. In addition, eliminating double taxation would narrow the tax base and thus necessitate higher marginal rates to achieve any given revenue target.

Consistent treatment of corporations and individuals

Another structural issue is the extent to which there should be consistency between the corporate and individual income taxes, both in terms of the tax bases and the tax rates. For example, if certain tax benefits are provided to corporations and not individuals, there may be an incentive to conduct business in the corporate form and there may be inequities and competitive advantages in favor of corporate business. Also, if the corporate tax rate exceeds the top individual tax rate and there is no double taxation of dividends, corporations will have an incentive to pay out earnings as dividends up to the point where their dividends-paid deduction exhausts their taxable income. This would represent a significant change in the pattern of corporate finance.

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[7] Under many integration proposals, the amount of the gross-up would be determined by a simple arithmetic formula whereby the shareholder would multiply his dividend by 1.85 regardless of the amount of tax the corporation actually paid. This is derived as follows: assume $100 of corporate pre-tax income. The corporate income tax is $46, leaving $54 to be distributed as a dividend. Thus, if the shareholder multiplies his dividend by 1.85, he will include the full $100 in income ($54x1.85=100). The shareholder's credit, then, would be 85 percent of the dividend, or $46. If the corporation actually paid $40 owing to tax preferences, the corporation would have to pay an additional tax of $6.

3. Noncash income

Income that is received in a form other than cash often presents problems in an income tax, particularly when the cash value of the income is hard to determine. The principal types of noncash income include compensation for services paid as fringe benefits and imputed rent on owner-occupied homes and consumer durables.

Fringe benefits

Present law excludes certain statutory fringe benefits from gross income and, generally beginning in 1985, taxes all other fringe benefits at the excess of their fair market value over any amounts paid by the employee for the benefits.[8] In most cases, the statutory fringes were intended by Congress as tax incentives for employers to provide compensation in particular ways, and some of the statutory provisions contain restrictions designed to carry out Congress' intent that these fringe benefits should be widely available (e.g., coverage requirements for qualified pension plans). In other cases, the statutory fringes were intended to codify established practices where business reasons, other than simply providing compensation, were adduced for employers to encourage employees to use the products they sell.

Under the proposals discussed here, the tax base would be broadened by repealing some of the present exclusions for fringe benefits. These benefits may be difficult to tax in certain situations. Issues that are often encountered with respect to fringe benefits include the valuation of the benefit (on the basis, e.g., of fair market value or employer's cost), the allocation to individuals of benefits made available to employees as a group,[9] and consistent treatment of one large benefit with various smaller benefits that aggregate to the same value but involve much more effort to account for.

Imputed income

The two principal types of imputed income are rent on owner-occupied homes and consumer durables. It has been argued that a homeowner, under a pure income tax, would be treated as someone in the business of renting his house. He would report as income the fair market rental on the house (imputed rent) and deduct all the costs associated with the house, including interest, taxes, utilities and depreciation. Under present law, imputed rent is not taxed, deductions are allowed for interest and taxes, and deductions are denied for utilities, depreciation and most other costs associated with homeownership. Thus, the tax preference for homeownership

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[8] The statutory fringe benefits excluded from gross income include group-term life insurance (sec. 79), a $5,000 death benefit exclusion (sec. 101(b)), accident and health plan benefits and contributions (secs. 105 and 106), the rental value of parsonages (sec. 107), meals and lodging furnished for the convenience of the employer (sec. 119), prepaid legal services (sec. 120), van pooling services (sec. 124), educational assistance (sec. 127), dependent care assistance (sec. 129), certain in-kind benefits and cash payments to military personnel, miscellaneous benefits (sec. 132), qualified pension plans (sec. 401), and incentive stock options (sec. 422A). However, the employer is denied a deduction for the bargain element of incentive stock options.

[9] Allocation would not be necessary in a flat-rate system with the corporate tax rate equal to the individual rate because businesses could simply be denied a deduction for certain fringe benefits, which could be excluded at the individual level.

equals the imputed rent minus the nondeductible costs.[10] Consumer durables are treated the same way: no imputed rent is included, but a deduction is allowed for "consumer" interest and taxes.

Few people seriously propose taxing imputed rent on owner-occupied homes or consumer durables because valuing the rentals would be extremely complicated and there is a public policy to encourage homeownership.[11] Rather, proposals to scale back the homeowner and consumer durable preferences generally take the form of limits on, or repeal of, the mortgage or consumer interest and property tax deductions. However, these proposals are not entirely free from problems of their own. Unless it were accompanied by repeal of the deduction for other nonbusiness taxes, repeal of the property tax deduction could be viewed as discriminating against those States and localities that rely disproportionately on the property tax. Limits on, or repeal of, the mortgage and consumer interest deductions tend to cut back the preference in proportion to the extent that the taxpayer finances his home or durables with debt rather than equity, and such a nonuniform scaling back of preferences may make the system less, rather than more, equitable. Furthermore, there is a practical problem that money is fungible and that there is no real economic distinction between mortgage and consumer interest, on the one hand, and other kinds of interest that are legitimate deductions in a tax on net income, on the other. However, the tax system has traditionally made a distinction between personal and business expenditures.

These types of considerations lead to other proposals for reducing the distortions and inequities associated with the treatment of interest and homeownership. For example, it has been suggested that all interest deductions be limited to investment income. None of the proposals discussed in the Appendix attempt to tax imputed rent on homes or durables; however, several repeal or limit interest and tax deductions.

4. Unrealized income

Some types of income consist of increases in the value of assets prior to the time when the taxpayer actually receives the income, such as by selling or exchanging the assets. Taxing such unrealized income would present two problems: (1) in some cases, it may be difficult to value the asset in order to measure the income properly; and (2) the taxpayer may not have access to cash with which to pay his tax.

Capital gains and losses is the area where unrealized income creates the most serious problems. Assuming that taxing gains and deducting losses as they accrue is ruled out because of the valuation

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[10] This is not the way homeowner preferences are treated in the annual tax expenditure budgets published by OMB, CBO, and the Joint Committee staff. In those documents, the tax expenditure for homeownership is defined as the mortgage interest and property tax deductions, on the assumption that taxing imputed rent is not a serious possibility. Only for a house which is entirely debt-financed and whose value is equal to its purchase price will the two measures of the preference be similar.

[11] However, it should be noted that the United Kingdom taxed imputed rent on homes for over a century—from the beginning of its income tax to 1963. By that date, the property value assessments on which the determination of imputed rent was based had been rendered obsolete by inflation, and the U.K. decided to exempt imputed rent rather than update the assessments.

and liquidity problems,[12] the only alternative is to tax them when realized; that is, when the asset is sold or exchanged or some other recognition event occurs. Because selling an asset is generally within the taxpayer's discretion, a tax on realized gains gives taxpayers an incentive to defer realization in order to postpone the tax.[13] This, in turn, has been a justification for providing preferential treatment for long-term capital gains, the argument being that full taxation of such gains at high ordinary rates would discourage sales of appreciated property to such an extent that it would be counterproductive. On the other hand, the delay in realizing the gain and paying tax on the gain also reduces the burden of the tax. Thus, the present law treatment of capital gains may give preferential treatment to investments whose return is predominantly in the form of gains (rather than current profits or dividends). Moreover, the fact that realization of gains and losses is discretionary has been the justification for imposing limits on the deductibility of capital losses.[14] Without such limits, taxpayers who own a variety of assets could realize their losses and defer their gains, thereby escaping tax despite the fact that they had substantial real income. Thus, the treatment of capital gains deviates in a number of respects from what would exist in a pure income tax.

In recent years, Congress has moved towards taxing some unrealized income, generally in areas where the valuation and liquidity problems were not significant, the income tended to be received by sophisticated taxpayers, and there was serious potential for tax avoidance. In 1969, Congress required periodic inclusions of discount income on corporate original issue discount bonds.[15] In 1981, Congress adopted a mark-to-market system of accrual taxation for commodity futures contracts, and in 1984 extended that system to many options transactions.

5. U.S. taxation of international transactions

The present U.S. tax system as it affects international transactions generally reflects a policy of capital export neutrality, under which the tax system would be neutral in the decision to invest in the United States or abroad. Analyzing the U.S. tax system with a view to fundamental reform could involve examination of current policy, measures to conform the new system to the international tax policy that is chosen, and certain less fundamental but nonetheless important issues.

Most of the proposals discussed in this pamphlet generally do not affect the basic system of U.S. taxation of international transactions. Some would conform the U.S. tax law more closely to the

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[12] It may be noted that Canada recently adopted an elective system for taxing corporate stocks that involves taxing gains as they accrue.

[13] Furthermore, the present rule under which an heir steps up the basis of inherited assets to the fair market value for estate tax purposes means that holding onto appreciated property can ultimately result in escaping any income tax on the appreciation.

[14] Currently, individuals may deduct capital losses against capital gains and up to $3,000 of ordinary income. Unused capital losses may be carried forward. Corporations may not deduct capital losses against ordinary income. Their carryforward is limited to 5 years, but they get a 3-year carryback.

[15] In the Tax Equity and Fiscal Responsibility Act of 1982, the inclusion formula was revised and periodic inclusion was extended to noncorporate bonds and stripped coupon bonds. The Tax Reform Act of 1984 further extended periodic inclusion to certain debt obligations previously exempted from the 1982 provisions.

principle of capital export neutrality. A few would repeal the foreign tax credit for individuals.

Taxing jurisdiction

The United States asserts jurisdiction to tax "United States persons" (including U.S. citizens, residents, and corporations) on their worldwide income, but allows a credit against the U.S. tax on income that arises abroad for foreign taxes paid. The United States also asserts jurisdiction to tax foreign taxpayers on U.S. source income and on certain foreign source income that is effectively connected with a U.S. trade or business. The United States taxes foreign taxpayers who earn passive income in the United States on their gross income, while foreign taxpayers who earn active income from a U.S. trade or business are subject to U.S. tax on their net income at the ordinary progressive rates that apply to U.S. persons. These gross taxes are often reduced or eliminated by treaty.

U.S. source rules

Because the United States distinguishes between U.S. source income and foreign source income whether the person earning the income is a U.S. person or a foreign person, the determination of the source of income (where income arises) is fundamental in the U.S. tax system. A general examination of the U.S. tax base would involve examination of the United States' source rules.

Under the current U.S. rules, U.S. source income includes, generally, income from personal services performed in the United States, rentals or royalties from property located in the United States, gains from the sale of U.S. real property interests, and interest or dividends paid by U.S. persons. The definition of foreign source income mirrors the definition of U.S. source income in some respects, so that foreign source income includes, generally, income from personal services performed outside the United States, rentals or royalties from property located outside the United States, income from the sale of foreign real property, and interest or dividends paid by non-U.S. persons.

Under the U.S. tax rules governing income from imports and exports, income from the production of property in the United States and its sale abroad may be one-half U.S. source and one-half foreign source. Income of a foreign person from the sale or from the production and sale of property produced outside the United States will bear no U.S. tax—regardless of whether the seller has a U.S. selling agent or a related U.S. party who sells the property in the United States—so long as the seller does not directly engage in trade or business in the United States.

The calculation of net U.S. source income requires the allocation and apportionment of deductions between U.S. source and foreign source income. If deductions that should reduce foreign source income are instead allowed to reduce U.S. source income, an improper reduction of U.S. revenues can result to the extent that the foreign source income is already effectively free of U.S. tax due to the operation of the foreign tax credit. Thus, rules relating to the allocation and apportionment of deductions are as significant as rules which determine the source of gross income.

Avoiding double taxation

When a resident of one country earns foreign source income (income that arises outside the home country), the possibility of double taxation arises because the income may be subject to tax both in the country in which it is earned and in the home country. Countries generally have chosen between two theoretical models for mitigating this double taxation. These are the foreign tax credit method, which the United States uses, and the territorial method.

Under the foreign tax credit method, a country includes the worldwide income of its residents in its tax base, but allows them a credit for foreign taxes paid against the tax it would otherwise impose on their foreign source income. Use of the foreign tax credit method is generally consistent with the principle of capital export neutrality, according to which residents pay the same tax when they earn income abroad as when they earn income at home. Under this principle, if the foreign operations of an enterprise are in a country that imposes the same effective tax rate as the home country, there is no home country tax on that foreign source income. If the foreign operations are in a country with a lower tax rate than the home country, the home country, if it seeks capital export neutrality, imposes tax at a rate equal to the difference between its rate and the source country's rate. If the foreign operations are exclusively in a country with a higher tax rate, then the capital export neutrality principle will not be satisfied if credit is not provided for foreign taxes in excess of the home country rate. Most highly industrialized countries, and most of the major trading partners of the United States (including Canada, Germany, Japan, and the United Kingdom), tax worldwide income and allow a foreign tax credit, generally like the U.S. credit, to avoid international double taxation.

Under the territorial method, a country exempts the foreign source income of its residents from its own tax base. Use of the territorial method by all counties would result in capital import neutrality, so that enterprises operating in a source country would be subject to the same total tax whether their residence is local or foreign. A few highly industrialized countries (Belgium, France, and the Netherlands) exempt some foreign source income from taxation. None of the world's highly industrialized countries exempts all foreign source income from tax, so none has a pure territorial tax system.

Although the United States generally uses a foreign tax credit method of avoiding double taxation, it has adopted a limited exemption approach in three cases. First, as a general rule, a U.S. corporation operating in Puerto Rico or another U.S. possession may elect an effective exemption from U.S. tax on income (other than certain income from intangibles) it earns in a possession. Second, in some cases, the United States does not tax the first $80,000 of annual income that a U.S. citizen or resident earns from personal services performed abroad. Third, the Foreign Sales Corporation rules will exempt from U.S. tax some income from export sales if management of a foreign corporation and certain economic processes take place outside the United States. Some of these rules would be revised under some of the proposals.

Foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not reduce the U.S. tax on U.S. source income. Accordingly, a limitation is currently provided to insure that the credit offsets only the U.S. tax on the taxpayer's foreign income. The limitation operates by prorating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") between its U.S. and foreign source taxable income. The ratio of foreign source taxable income to total taxable income is multiplied by the total pre-credit U.S. tax. This establishes the amount of U.S. tax liability on the foreign income and, thus, the upper limit on the foreign tax credit.

The current limitation is an "overall" limitation, because the taxpayer aggregates income and losses from all foreign operations in calculating the limitation. For example, if 60 percent of the taxpayer's taxable income is from all foreign sources combined, then the foreign tax credit is limited to 60 percent of the pre-credit U.S. tax. One alternative to the overall limitation is a "per-country" limitation, under which the taxpayer would determine the foreign tax credit on a country-by-country basis. This means that the taxpayer would take a foreign tax credit for taxes paid to any particular foreign country only to the extent that the taxes paid to that country did not exceed the limitation separately determined for that country. In other words, under the per-country limitation, taxes paid to any foreign country could be used as credit only against the portion of the total pre-credit U.S. tax which was allocable to income from sources within that country.

The overall limitation is favorable to taxpayers who incur high foreign taxes in one country and who earn other foreign source income that bears a relatively low rate of tax, since these taxpayers may effectively be allowed full credit for the high foreign taxes even when they exceed the U.S. rate. The per-country limitation, by contrast, could be favorable to taxpayers with income in one or more foreign countries and foreign losses elsewhere. While it would prevent crediting taxes from any country at a rate in excess of the U.S. rate, the per-country limitation could allow the combination of full foreign tax credits for one country's taxes and a loss in another country to reduce the U.S. tax on U.S. source income. At various times, the United States has limited the foreign tax credit in four ways: (1) an overall limitation, (2) a per-country limitation, (3) allowing taxpayers to choose the more favorable of the overall and the per-country limitations, and (4) requiring use of the less favorable of those methods. However, alternative limitations on the foreign tax credit might also be considered.

Deferral of tax on earnings of foreign corporations

Under current law, United States persons who invest directly in foreign countries are subject to current U.S. tax on their foreign income (subject to a foreign tax credit that may offset U.S. tax on that foreign income). U.S. persons who invest abroad through for-

eign subsidiary corporations generally defer tax on the undistributed earnings of the subsidiaries until repatriation.[16]

It has been argued that the current system of deferral of the undistributed earnings of U.S.-owned foreign corporations does not comport with the principle of capital export neutrality. By allowing U.S. companies to operate in foreign countries under local tax rules rather than U.S. tax rules, deferral can create a U.S. tax preference for foreign investment over U.S. investment in cases where local rules produce the smaller tax. If Congress reduces incentives for U.S. investment in conjunction with a major revision of the U.S. income tax, the significance of this preference would be increased.

Some have argued that repeal of deferral could simplify rules governing the treatment of foreign income and could reduce or eliminate a variety of tax-planning opportunities that arise upon the interposition of a foreign corporation between a taxpayer and its foreign source income. These opportunities include (1) the ability to manipulate the foreign tax credit that arises when taxpayers conduct some foreign operations directly, and other foreign operations through foreign subsidiaries, (2) the opportunity for U.S. taxpayers to decide when certain income will become subject to U.S. tax, and (3) the incentive for U.S. taxpayers to avoid U.S. tax by undercharging foreign subsidiaries for goods or services. Further, deferral may create incentives for U.S. taxpayers to reinvest profits derived from foreign operations in those operations rather than in potentially more productive investments in the United States.

Others contend that repeal of deferral could discourage exports, because some foreign subsidiaries of U.S. persons sell U.S. goods abroad and benefit from deferral. Repeal could engender a significant audit burden on the Internal Revenue Service. It has also been argued that repeal would result in unfavorable reactions by foreign countries where U.S. persons form foreign subsidiaries.

6. Consumption taxes and the treatment of savings

A number of analysts believe that the individual income tax should be replaced by a tax on consumer spending, so that the types of savings currently in the tax base would be exempt. In general, their analysis is that national welfare would be increased if greater savings could be funneled into greater investment that ultimately leads to higher levels of production. Two taxes that have been discussed in this regard are the consumed income tax and the value-added tax.

Consumed income tax

Individuals would continue to be the tax filing units under a consumed income tax. It would not be necessary for taxpayers to add

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[16] Congress has enacted certain exceptions to this deferral. In 1935, Congress required the individual shareholder of each personal holding company (a U.S. corporation earning primarily passive income) to include in income his or her share of the company's undistributed earnings. In 1937, Congress enacted similar rules for foreign personal holding companies. In 1962, Congress required any 10-percent U.S. shareholder of a controlled foreign corporation to include in income (subject to a foreign tax credit) a pro rata portion of the undistributed earnings of the foreign corporation that arise from designated activities (such as passive investment, certain related party transactions, and, effective in 1983, certain oil-related activities).

up all their purchases of consumer goods and services. Rather, a consumption tax could be implemented through several modifications of the income tax, which make use of the arithmetical result that a person's after-tax income is either spent on consumption or saved. Thus, a consumption tax base could be implemented by starting with an income tax base, allowing taxpayers to deduct all purchases of assets during the year, all tax payments, and all repayment of debt, and requiring them to add to the tax base the proceeds from all sales of assets and from all borrowing. A graduated rate structure could be applied to this base to produce a progressive tax, like the current income tax. Moreover, because a consumed income tax, like the current income tax, would be a personal tax, any additional personal circumstances (such as family size) which may be deemed relevant to equitable taxation could be taken into account. Although there is a history of academic analysis of the consumed income tax, it appears that only India and Sri Lanka have had experience with implementing it. Both countries have since repealed their consumed income tax.

Value-added tax

Businesses would be the tax filing unit under a value-added tax. The value added by a business, and the base of the consumption-type value-added tax, is the difference between its sales proceeds and the cost of raw materials, semi-finished goods, capital goods, and other items that it has purchased from other businesses. Thus, if a business has sales of $100 and purchases $80 of goods and services from other businesses, its value added is $20. This will equal the sum of the wages and salaries it pays for the use of labor, the interest it pays for the use of capital, and its profits. Under one method of tax computation, the business would apply the tax rate to this base and remit the tax. Under an alternative method, generally used in Europe, the business would compute a tentative tax on sales proceeds and a tentative tax credit for purchases from other businesses and then remit the difference. Since the value-added tax on all sales to other businesses would be offset by subsequent tax credits, the only value-added tax that matters from the standpoint of overall revenues is the tax collected at the retail level, where there is no offsetting credit. (Thus, some argue, a third alternative would simply be to impose a national retail sales tax.) Exporters would claim a rebate for the value-added tax they paid when they acquired the goods for export, and importers would pay tax on the value of imported goods.

Conceptually, there are several types of value-added taxes, differentiated by their treatment of the cost of capital goods. The consumption-type of value-added tax is generally in use in European countries, where standard tax rates cluster between 15 and 20 percent. In many countries, exemptions or reduced tax rates are provided for numerous items—food, housing rent, medical services, water and newspapers are examples—while tax rates above the standard tax rate may apply to luxury items. In many cases, these value-added taxes succeeded other consumption taxes, such as a turnover tax on all sales, a manufacturers' sales tax, a wholesalers' sales tax or a retail sales tax. The turnover tax has been criticized for effectively imposing a higher tax on value added early in the

production and distribution process (because it is taxable again in later stages), thus providing incentives for businesses to integrate vertically. A manufacturers' or wholesalers' sales tax would alleviate this problem, because they are single-stage taxes; however, by failing to tax value added at the retail stage, such taxes create distortions against products where little value added occurs at the retail level.

Consumption taxes may be levied on a more limited basis for the purposes of raising revenue, discouraging consumption of specific products, or financing public expenditures closely related to the consumption of specific products. For example, the United States currently imposes taxes on the consumption of communications services, alcoholic beverages, cigarettes, air transportation, and highway motor fuels.

Effect on incentives

Proponents of the consumption tax base argue that the income tax, by taxing income from capital, encourages taxpayers to consume their income now rather than save for future consumption and that a consumption tax would not distort this decision. Advocates of the income tax do not generally dispute this proposition but argue that the effect is not large enough to justify a change, that society can increase its saving by reducing government budget deficits, that other economic inefficiencies would be caused by the high marginal tax rates which would be necessary if saving were excluded from the tax base and that, in any event, the emphasis on savings (rather than consumption) as the key to economic growth is misplaced.

Equity

Advocates of the consumption tax also argue that such a tax would be more equitable. Consider a simple example in which two taxpayers each earn $100. One consumes his after-tax income immediately, while the other invests it at 10 percent and consumes the proceeds the next year. Under an income tax with a 50-percent rate, both taxpayers would pay $50 in the first year, but the saver would pay an additional $2.50 on his $5 in the second year. Under a consumption tax, the taxpayer who spends in the first year would pay $50 that year, while the saver would pay $55 in the second year; that is, the present value of their tax burden would be the same. (Under an income tax limited to personal service income, they both would pay $50 in the first year, so that their tax burdens would be identical in both years.) Proponents of a consumption tax argue that these two taxpayers are similarly situated because they have exactly the same opportunities over the two-year period and that it is equitable for them to pay the same tax either directly (as in an income tax on personal service income) or in present value terms (as in a consumption tax).

Critics of the consumption tax approach argue that a year-by-year comparison is more appropriate than a lifetime perspective and that, from this standpoint, the two taxpayers are only similarly situated in the first year, with the saver better off in the second year and, hence, able to pay more tax that year. They also argue that the equity argument in favor of the consumption tax hinges

on treating bequests as consumption and taxing them as such when a person dies. This, however, would be a controversial aspect of any consumption tax, since the bequests would be taxed again when consumed by the heirs. Moreover, taxpayers who are consuming more than their income because they are facing hard times, like the unemployed, would fare worse under a consumption tax than under an income tax, which may not be considered a fair result. Other taxpayers whose burdens would be higher under a consumption tax would include the elderly and parents putting their children through college. Perhaps most fundamentally, critics doubt that vertical equity in the distribution of tax burdens, gauged relative to the ability to pay taxes, can be achieved under a consumption tax.

Problems with the income tax

One argument for a consumption tax is that it would moot many of the questions that make it difficult to structure an income tax. A consumption tax would require no special rules for indexing the definition of income from capital and borrowing for inflation, capital gains and losses, depreciation, inventory accounting, or unrealized income.

However, some structural problems with the income tax, like the treatment of many fringe benefits and of imputed income, would remain. Moreover, a consumption tax would create some new problems, like the treatment of gifts and bequests and the multitude of distinctions necessary to implement any exemptions or differential tax rates (as between necessities, standard goods and services, and luxuries, for example) that may be deemed necessary for furthering equity goals or other social considerations. In addition, a consumption tax could present difficult international issues, such as the treatment of accumulated wealth at the time of emigration or immigration. If the wealth were disregarded, for example, then a U.S. citizen could save tax-free and later emigrate to an income tax country to consume the accumulation tax-free, with a consequent revenue loss to the Treasury; whereas a foreigner who had saved in an income tax country and immigrated to the United States would be taxed on both the accumulation and consumption of his or her savings.

Marginal tax rates

A consumption base would be narrower than a comprehensive income base (although not necessarily narrower than the present income tax base), and higher-income people tend to save a larger percentage of their income than others. Therefore, to raise a given amount of revenue with a given degree of progressivity, the consumption base would require higher marginal tax rates than an income base. These higher rates would increase the ill effects of whatever distortions remained in the consumption tax system.

Transition issues

There would be difficulties in effecting a transition from an income tax to a consumption tax. It would seem unfair, for example, to tax consumption of wealth which had been accumulated out of after-tax income under the prior income tax. A transition rule to

prevent such double taxation, however, such as allowing taxpayers to deduct the basis of assets held on the effective date of the consumption tax in order to grandfather consumption of previously taxed income, would have a large revenue loss in the early years of the tax and would virtually exempt many wealthy people from tax for a period of years.

C. Tax Expenditure Provisions

In addition to addressing the structural problems outlined above, a thorough review of the income tax would have to confront the variety of special provisions that have been added to the law over the years to provide incentive for particular kinds of activities or to provide relief to particular kinds of taxpayers. There are more than 100 such tax expenditure provisions, many of which have been enacted since 1976. They include exclusions for certain kinds of income, deductions for costs other than the costs of earning income, tax credits, and tax deferral provisions.

In this regard, there are several important considerations. Tax expenditures have the advantage that they can be plugged into an administrative mechanism through which the government already communicates with a large number of its citizens. Tax expenditures do not generally require separate or detailed application forms, and they are received relatively quickly. On the other hand, most tax expenditures make the tax system more complex for the taxpayer and also reduce the extent to which the public perceives the system to be equitable. In addition, if the tax expenditure takes the form of an exclusion or deduction in a system with progressive rates, it provides a higher rate of subsidy to high income than to low income taxpayers, a result which may be undesirable. Unless the tax expenditure is refundable, it will not be available to taxpayers with no tax liability, and if such taxpayers are corporations, they may have a purely tax-motivated incentive to merge with taxpaying units. Tax expenditures may also cause administrative problems for the agency administering the tax system, which may be required to deal with policy issues outside its normal area of expertise. Tax expenditures have also been criticized for being, in effect, entitlement programs which are not reviewed each year as part of the appropriations process and not subject to the controls which the budget process imposes on new entitlement authority. (However, in recent years Congress has tended to put termination dates on many new tax expenditure provisions to encourage periodic review of them.) It has been argued that, as a practical matter, some tax expenditures would not have been adopted or would have been adopted in a much more limited form, if provided as budget outlays.

Analysis of tax expenditures generally involves two issues. First, whether the nontax policy goal accomplished by the tax expenditure is worth the lost revenue and whatever other tax policy goals are being sacrificed must be decided. This is likely to be based on efficiency (benefit-cost), distributional and administrative considerations similar to those discussed in the first part of this pamphlet. The second decision is whether other approaches to achieve the nontax policy goal, such as spending or regulation, would be prefer-

able. After reviewing tax expenditure provisions as part of an overhaul of the income tax, Congress could decide that the nontax policy goals of certain tax expenditures should be accomplished with spending programs, in which case not all the revenue raised by broadening the tax base would be available to finance tax rate reductions. For example, if the charitable deduction were repealed, Congress might want to enact a spending program under which the federal government matches private contributions to charitable organizations. Conceivably, this matching grant program could cost as much as the revenue loss from the deduction.

The proposals discussed in the Appendix would repeal many or most of the tax expenditure provisions and use the resulting revenue gain to finance tax rate reductions.

D. Technical Issues and Incremental Reform

One of the reasons often expressed for comprehensive tax reform is that the system has become too intricate and that the pace and complexity of recent tax legislation are too much for even sophisticated tax advisers to deal with. While some of the current complexity may be eliminated under the various proposals, certain sources of complexity would remain for consideration. In particular, the comprehensive tax reform proposals do not address all of the technical issues that often are sources of much complexity. For example, many of the technical issues that were dealt with in recent legislation, such as the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984, would also need to be considered under a revised tax system.

The specific issues would depend upon the proposal under review. Issues related to the time value of money would be of much less significance under a consumed income tax, but rules concerning partnerships and trusts would need to be examined because problems of income spreading and separating deductions and income among taxpayers would still exist. Under a broadly based income tax system, the technical rules governing corporate reorganizations, partnerships and trusts, and activities that involve the time value of money would still need attention. Although such issues tend to be less significant in a system with lower marginal tax rates, the associated rules may nevertheless be complex.

In fact, some have argued that the ongoing review that is needed to maintain any tax system provides another possible path to comprehensive tax reform. That is, in the course of periodically considering legislation similar to the 1982 and 1984 Acts, Congress could examine a variety of tax preferences and technical issues that might have significant revenue savings which could be used to lower marginal tax rates.

IV. ISSUES IN TRANSITION TO A NEW TAX SYSTEM

A. Overview

Standards of equity, efficiency and simplicity that are used to evaluate the present tax system or a comprehensive income tax system also can be used to evaluate what happens in the transition from one to the other.

Equity issues arise in transition because contracts and investments which are marginally profitable under the current system could be made highly profitable or unprofitable by the new system. Taxpayers who made tax-preferred investments under the current rules could experience a sharp decline in current (after-tax) income and in wealth—the capitalized value of future income—relative to taxpayers holding ordinary investments. This reduction in wealth might be regarded as particularly inequitable when the tax preference was enacted by Congress in order to achieve certain social or economic objectives, as in the case of tax-free municipal bonds. On the other hand, windfall gains could occur for investments that are treated relatively more favorably under the new system. One function of transitional rules is to moderate changes in wealth that follow from changes in tax law.

Efficiency issues arise because taxpayers would consume resources in adjusting to a new tax system. The loss of these resources is a transitional cost of tax restructuring, and a second function of transitional rules is to minimize this cost.

Simplicity is a consideration in the transition from one tax system to another. As seen in the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984, transitional rules designed to moderate wealth effects of repealing or curtailing tax preferences can be quite complicated, especially when the preferences are widely utilized.

B. General Transition Rule Options

There are two general types of transition rules: (1) grandfather clauses and (2) phase-in provisions. Grandfather clauses permit or require contracts and investments, initiated under the old tax rules, to be governed by the old law. If the grandfather clause is available on an elective basis, the taxpayer can avoid being made worse off as a result of the tax change; while if the clause requires old-law tax treatment, then some windfall gains, due to the tax law change, are also eliminated. A grandfathering provision may apply to all eligible investments or be limited to owners of the investment at the time the change in tax rules was first considered or enacted. If the clause is limited to the original owner, then taxpayers may not be protected against windfall losses if the investment is sold to another, ineligible, investor. If the investment, rather

than the owner, is grandfathered, then the owner is protected against a windfall loss even if the investment is sold after the tax law change; indeed, since the grandfather clause creates a limited supply of old-law investments, original owners may reap windfall gains under such a rule. Also, if a tax change has been widely anticipated for a long time prior to enactment, asset values may reflect the likelihood of the change, and a grandfather rule may lead to windfall increases in asset values.

Phase-in provisions may be used to delay the effect of new tax rules on both existing and new investments. With respect to existing investments, a phase-in rule provides temporary and partial protection of asset values compared to an elective grandfather clause. The longer and more gradual a phase-in rule, the more similar it is to a grandfather clause. In the limit, if the new tax rules are only phased-in after existing investments are scrapped, then the phase-in provision is precisely equivalent to a grandfather clause for existing investments. However, since many investments, such as homes, last 30 years or more, very long phase-in rules would be required to effectively grandfather all existing investments. With respect to new assets, the effect of a phase-in period is primarily to slow the rate of transition, thereby allowing taxpayers adequate time to adjust. Phase-in provisions may broaden the tax base by degrees, with an opportunity to reassess policy at each step. Alternatively, the phase-in may simply be a grace period in advance of a one-time, major change in rules. Both a gradual phase-in and a grace period moderate wealth changes on existing assets and provide taxpayers time to adjust.

Criteria for selecting between the alternative grandfathering and phase-in approaches include the following: (1) effectiveness in achieving the twin goals of moderating adverse wealth effects and providing taxpayers adequate time to adjust, (2) absence of incentives for taxpayers to make non-economic, tax-motivated investments during the transition period, and (3) simplicity of transition rules. It is unlikely that any one transition rule best satisfies all three criteria, so that the choice among alternatives requires judgement about the relative importance of these objectives.

C. Specific Issues in the Transition to a Comprehensive Income Tax

This section surveys some of the specific transition problems associated with eliminating some of the major exclusions and deductions.

Exclusions

Among the most important exclusions in the individual income tax are the exclusions for (1) transfer payments like social security and public assistance, (2) fringe benefits, and (3) 60 percent of capital gains. Including transfer payments in taxable income would reduce the benefit from these payments to recipients whose income exceeds the level at which people begin to pay tax. It would be possible to readjust benefit schedules to compensate for inclusion in taxable income for taxpayers with a particular marginal tax rate, but this could take Federal and State governments a period of sev-

eral years. To allow time for such compensating legislation, it may be appropriate to delay the effective date of repeal of the exclusion for transfer payments or to phase it in. To the extent benefits are not readjusted for inclusion or the taxpayer's marginal tax rate is higher than the rate on which the benefit readjustment was based, current and future recipients would be adversely affected.

Including fringe benefits in taxable income would reduce the effective salary of employees now benefiting from fringes. Taxpayers presumably would respond by substituting cash wages for some of the less desirable fringes, but this could take time (e.g., to renegotiate contracts). Moreover, there will be many cases in which workers have accrued fringe benefits where realization has not taken place. The simplest transition rule would be to allow a grace period of one or more years in which realization of accrued fringe benefits could take place under the old tax law and taxpayers would have time to modify compensation arrangements.

Including 100 percent of capital gains in taxable income (without reducing tax rates) would reduce the value of many assets. The reduction in value would be largest for assets whose return is disproportionately in the form of capital gains (e.g., gold and homes). While accrued but unrealized capital gains could be grandfathered by applying the new rules only to appreciation occurring after the effective date (a fresh start), this would require the segregation of assets acquired prior to the law change, and measurement of the market value of these assets. This approach was used when the original income tax was enacted in 1913 and when carryover of basis was enacted in 1976, but it created difficulties each time. An alternative approach would be to provide a grace period during which accrued capital gains could be realized under the present tax law. This, however, would give taxpayers an incentive to sell assets during the grace period, thereby distorting decisions. A third approach would be to retain existing law for assets owned on the effective date, but this could discourage sales of those assets. If tax rates are substantially lowered at the same time the capital gains exclusion is eliminated, the effective rate of tax on capital gains may not increase as a result of comprehensive income tax reform, which may reduce the need for transition rules; however, there still could be declines in the values of assets whose return consists disproportionately of capital gains.

Itemized deductions

The most important itemized deductions in the individual income tax are the deductions for interest, State and local taxes paid, charitable contributions, and medical expenses.

Eliminating the deduction for mortgage interest would significantly increase the tax liability of most homeowners as well as reduce the market value of most homes. Grandfathering interest paid on existing home mortgages would protect recent homebuyers from an increase in tax liability but would not prevent the present owners of the housing stock from suffering a loss in property value. To fully protect homeowners, old-law treatment would have to be accorded to the existing stock of housing in perpetuity. The transition problems associated with housing are especially difficult because housing is extremely durable and represents a large portion

of taxpayer wealth. One possible transition rule would be to allow existing homeowners to take a deduction or credit for the estimated reduction in property value due to the tax law change. While this would compensate the losers from eliminating the mortgage interest deduction, it would be difficult to estimate accurately the monetary loss. Alternatively, a phase-in could moderate the likely decline in home prices.

Elimination of the deduction against Federal income tax for certain kinds of State and local taxes paid would increase the tax liabilities of itemizing taxpayers who pay high State and local taxes. This would put some pressure on State and local governments to change their mix of tax revenues. Therefore, a grace period could be considered to give State legislatures time to make the appropriate adjustments.

Elimination of the charitable contribution deduction could reduce the level of charitable giving, perhaps substantially. This would reduce the revenue of organizations that rely on charitable contributions and could force a reduction in their programs and outlays. A phase-in period would provide time for charitable organizations to develop alternative sources of revenues and to bring expenditure plans in line with income.

The transition problems which arise in the adoption of a new system are numerous and often are different for the different provisions being changed. These transition problems should be considered one-by-one as discussions of comprehensive tax reform progress.

D. Interaction with State and Local Tax Systems

Major reform of the Federal tax system could create special problems with regard to the tax systems used by many States and localities. At present, all but 7 States, and some localities as well, impose an individual income tax. These State and local taxes typically are based upon Federal income tax concepts and computations. Some States make relatively few adjustments in the Federal income tax base to derive their tax base and others make more numerous adjustments. If the Federal income tax base were broadened significantly, many individuals would experience increased State and local tax liabilities and States and localities imposing an income tax would experience windfall increases in receipts, until such time as adjustments were made in tax rates or otherwise. Repeal of deductions for State and local taxes could alter the relative attractiveness of alternative State and local revenue sources.

If the Federal government shifted to a consumed income tax, most taxpayers would face the added complexity and burden of also complying with an income tax at the State level, unless the States quickly took steps also to shift to a consumed income tax.

If the Federal government were to impose a value-added tax or retail sales tax, issues of coordination with existing State and local sales taxes would have to be resolved. A Federal value-added or retail sales tax could, for example, be applied either before or after the imposition of any State or local sales tax or excise tax.

APPENDIX

SUMMARY OF TREASURY'S TAX REFORM PROPOSAL AND COMPREHENSIVE TAX BILLS INTRODUCED DURING THE 99TH CONGRESS

Overview

In November 1984, the Treasury Department published its report, *Tax Reform for Fairness, Simplicity, and Economic Growth* (3 Vols.). In addition, several bills which address comprehensive income tax reform have been introduced so far during the 99th Congress. Generally, these proposals would broaden the income tax base by repealing or modifying tax preferences and would lower and flatten the individual income tax rate schedule. A number of these initiatives also address structural issues in the current income tax system, including the marriage penalty, the treatment of saving, the effect of inflation in defining income from capital, and the relationship between the corporate and individual income taxes. These comprehensive income tax proposals range along a spectrum from those with a very broad base and a low flat rate to less broadly based taxes with moderately progressive rates. A brief summary of these proposals follows.

Taxpayers Affected

—Applies to all taxpayers.

Tax Rates

Individuals

—3 brackets with marginal tax rates of 15, 25 and 35 percent.
—Zero bracket amount increased to $2,800 for single returns ($3,800 for joint returns).
—Personal exemption increased to $2,000.
—Earned income credit indexed for inflation.

Corporations

—All income taxed at 33 percent.

Selected Provisions

Exclusions, deductions and credits

—Numerous exclusions repealed.
—Exclusion of employer-paid health insurance retained but limited.
—Interest on new private-purpose governmental bonds not exempt.
—Taxes not deductible unless business-related.
—Personal interest (other than housing interest) deductible only to the extent of investment income plus $5,000.
—Charitable contributions deductible only by itemizers to the extent they exceed 2 percent of adjusted gross income, and deduction for donating appreciated property limited to indexed basis.
—Deduction limit for individual retirement accounts (IRAs) increased to $2,500 and equivalent spousal IRAs allowed.

Investment

—Investment tax credit repealed.
—Accelerated Cost Recovery System (ACRS) replaced by depreciation indexed for inflation and designed to approximate the real decline in asset value.
—Rapid amortization rules generally eliminated.
—Percentage depletion replaced by cost depletion indexed for inflation, and intangible drilling costs capitalized rather than expensed.
—Capital gains taxed at ordinary rates, and basis indexed for inflation for determining gain or loss.
—Interest receipts and payments generally indexed for inflation.
—Inventories indexed for inflation at taxpayer's option.

—Corporations allowed to deduct 50 percent of dividends paid.
—Bad debt deduction limited to actual loss for year.
—Partnership taxed as corporation if 35 or more limited partners.
—Matching of income and expense required for multiperiod production activities.
—Deductibility of interest incurred by depository institutions to carry tax-exempt bonds denied.

H.R. 200 (Mr. Siljander)

Ten Percent Flat Tax Rate Act

Taxpayers Affected

—Applies only to individuals and unincorporated associations, including partnerships.

Tax Rate

—Single tax rate of 10 percent.
—Personal exemption increased to $2,000.

Selected Provisions

—Many existing exclusions repealed, including capital gains.
—Existing deductions denied, except for business or income-producing expenses, IRA contributions, charitable contributions, taxes, and interest.
—Tax credits generally not available.
—Taxpayers granted a 3-year amnesty period for reporting prior underpayments of tax.

H.R. 373 (Mr. Moore) And S. 243 (Senator Roth)

Broad-Based Enhanced Savings Tax Act of 1985 ("BEST")

Taxpayers Affected

—Applies only to individuals.

Tax Rates

—4 brackets with marginal tax rates of 12, 20, 30 and 34 percent when fully phased in.

—Earned income credit increased to a maximum of $676 and indexed for inflation.

Selected Provisions

Exclusions, deductions and credits

—Numerous exclusions repealed, not including current treatment of tax-exempt bonds.

—Existing itemized deductions repealed, except medical expenses over 10 percent of adjusted gross income, housing interest, and charitable contributions.

—Nonrefundable tax credits generally denied.

Savings and investment

—Contributions up to $10,000 per year ($20,000 for joint returns) to a super savings account (SUSA) deductible when made and income earned on SUSA assets excludable; distributions includible when made, but no penalty for distributions.

—Expensing of personal property replaces depreciation over a 5-year transition period, during which the investment credit is phased out.

—Capital gains taxable as ordinary income.

H.R. 416 (Mr. Quillen)

Flat Rate Tax Act of 1985

Taxpayers Affected

—Applies only to individuals.

Tax Rate

—Single tax rate of 10 percent.
—Personal exemption increased to $2,000.

Selected Provisions

—Existing exclusions repealed, except for social security benefits, veteran's benefits and certain tax-exempt interest.
—Existing deductions denied, except for charitable contributions, investment interest and interest on the principal residence, income and real property taxes, and business expenses.
—Tax credits repealed.

H.R. 623 (Mr. Don Young)

Flat Rate Tax Act of 1985

Taxpayers Affected

—Applies only to individuals.

Tax Rate

—Single rate of 15 percent on income over $10,000.

Selected Provisions

—All exclusions repealed.
—All deductions repealed, except charitable contributions, interest on the principal residence, and business expenses.
—All credits repealed.
—Taxpayer protection augmented when levy is made on property for unpaid taxes.

H.R. 777 (Messrs. Kemp and McEwen) and S. 325 (Senator Kasten)

Fair And Simple Tax Act of 1985 ("FAST")

Taxpayers Affected

—Applies to all taxpayers.

Tax Rates

Individuals

—Single tax rate of 24 percent.

—Zero bracket amount increased to $2,600 for single returns ($3,300 for joint returns).

—Personal exemption increased to $2,000 and current exemption for dependent students eliminated.

—Earned income credit modified and indexed for inflation.

—New exclusion allowed for 20 percent of employment income up to the social security maximum wage base; and additional inclusion required of 20 percent of gross income above this wage base.

—Current inclusion of social security benefits reduced, and social security benefit reduction for excess earnings ultimately repealed.

Corporations

—3 brackets with marginal tax rates of 15, 25 and 35 percent.

Selected Provisions

Exclusions, deductions and credits

—Numerous exclusions repealed, including tax exemption for interest on private purpose governmental bonds.

—Deductions repealed for taxes other than real property taxes and for consumer interest unless related to housing or education.

—Medical expenses not deductible except those over 10 percent of adjusted gross income.

—Tax credits generally eliminated.

Investment

—Investment tax credit repealed.

—ACRS replaced by depreciation in excess of cost, over longer periods, and indexed for inflation to approximate expensing in present value.

—Rapid amortization rules generally eliminated.

—Capital gains indexed for inflation if taxed as ordinary income; alternatively, gains not indexed and taxed at preferential rates.

H.R. 800 (Messrs. Gephardt, Anthony, Dorgan, Flippo, Pease and others) and S. 409 (Senator Bradley and others)

Fair Tax Act of 1985

Taxpayers Affected

—Applies to all taxpayers.

Tax Rates

Individuals

—3 brackets with marginal tax rates of 14, 26, and 30 percent; 14-percent rate applies to taxable income and surtax rates of 12 and 16 percent apply to adjusted gross income above specified levels.

—Zero bracket amount increased to $3,000 for single returns ($6,000 for joint returns).

—Personal exemption of taxpayer increased to $1,600.

—Indexing of rate brackets, zero bracket amount and personal exemption repealed.

Corporations

—Single tax rate of 30 percent.

Selected Provisions

Exclusions, deductions and credits

—Numerous exclusions repealed, including income earned abroad and interest on private purpose governmental bonds.

—Deductions denied for nonbusiness sales taxes and interest (other than housing interest) in excess of investment income.

—Corporate deduction for charitable contributions limited to 50 percent of the contributions.

—Nonrefundable tax credits repealed, other than the foreign tax credit.

Investment

—Investment tax credit repealed.

—ACRS replaced by depreciation to approximate the real decline in asset value for a given range of inflation rates.

—Rapid amortization rules generally eliminated.

—Depletion replaced by depreciation.

—Preferential tax rates for capital gains repealed.

H.R. 1040 (Mr. Rangel)

Tax Equity and Simplification Act of 1985

Similarity with Treasury Proposal

—Bill is generally similar to Treasury proposal.

Differences with Treasury Proposal

—3 brackets for corporations, with marginal tax rates of 15, 25 and 33 percent.

—Present treatment of employer health plans retained.

—Itemized deductions for charitable contributions (except for Treasury's limitations on appreciated property) and State and local taxes retained.

—No provision for a corporate dividends-paid deduction.

H.R. 1165 (Mr. Heftel)

Cash Flow Income Tax Act of 1985

Taxpayers Affected

—Applies to all taxpayers.

Tax Rates

Individuals

—3 brackets with marginal tax rates of 10, 23 and 30 percent.
—Zero bracket amount increased to $4,000 for single returns ($6,000 for joint returns).
—Personal exemption replaced by nonrefundable $200 tax credit.
—Earned income credit repealed.

Corporations.

—Single tax rate of 30 percent.

Selected Provisions.

—Income tax replaced by consumed income tax.
—Most exclusions and deductions repealed.
—Deductions retained include charitable contributions (limited to 5 percent of adjusted gross income), medical expenses over 10 percent of adjusted gross income, income and sales taxes, casualty losses over $500, mortgage interest on a principal residence, investment interest, and interest paid in actively conducting a business.
—Tax credits repealed, including investment tax credit and foreign tax credit.

S. 321 (Senators DeConcini and Symms)

Taxpayers Affected

—Applies to all taxpayers.

Tax Rates

Individuals

—Single tax rate of 19 percent of income in excess of the personal allowance.

—Personal allowance is $4,500 for single returns ($9,000 for joint returns), plus $1,800 for each dependent.

Businesses

—Single tax rate of 19 percent of business taxable income.

Selected Provisions

—Workmen's compensation included in gross income.

—Payments for services performed outside the U.S. and fringe benefits excluded from gross income.

—Business taxable income generally defined as net cash flow.

—Indefinite carryforward of business losses allowed, and losses augmented for inflation.

—Subsidiaries allowed to file separately or in any combination, so long as taxable income of business is correctly reported in the aggregate.

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ERRATA FOR JCS-3-85 (FEB. 26, 1985)

1. The third item of page 41 should read:

   -- Partnership taxed as corporation if more than 35 limited partners.

2. The second item under the heading, "Individuals," on page 49 should read:

   -- Zero bracket amount increased to $4,000 for single returns ($8,000 for joint returns).

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